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The Ethics of Item Pricing

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ABSTRACT

Unbalanced bidding describes the process of contractors deliberately applying different mark-ups to individual items of work within a project. This practice has been shown to have the potential of yielding significant benefits to the contractor, including improved cashflow, higher compensation for escalation, and higher valuations for anticipated variations. A previous study on a hypothetical project indicated an improvement in profit in the order of 150% compared to balanced item prices. Research has indicated that unbalanced bidding is a widespread practice and yet many researchers have argued that it is unethical. This paper investigates the merits of these claims.

BACKGROUND

Item Pricing or unbalanced bidding, refers to a practice which contractors can utilise, besides and beyond that of deciding their overall bid price, in order to maximise their profitability and minimise their risks.

The tendering decision involves taking into account many different factors which contribute to the decision to bid, the decision of the overall mark-up rate for a project, and the decision on the individual prices for each of any such project's constituent items.

Item prices can be chosen to be 'balanced' or 'unbalanced'. Balanced prices are produced by applying the same mark-up to the estimated costs of all of a project's items. On the other hand, unbalanced prices are ones that are decided individually, inevitably implying a variety of mark-ups, aimed at achieving an outcome that is preferable to a balanced bid.

Unbalanced pricing offers the prospect of the following advantages over balanced prices:

Front End Loading – the improvement of the contractors' cashflow by way of pricing items scheduled to arise early on with higher mark-ups;

Quantity Error Exploitation – the safeguarding of higher likely variation orders by way of anticipating variations and pricing the associated items accordingly; and

Back End Loading – in instances of contracts with escalation clauses, the improvement of the contractors' compensation for inflation.

Contractors are obviously exposed to a number of risks and their pricing of a project has a profound effect on these. Cattell (2012) has identified the following three risks as being effected – potentially positively or negatively – by way of item pricing:

Rejection – Prices within an inner 'range of acceptance' are unlikely to give cause for a client to reject a contractor's prices. However, the further prices fall outside of this inner range of normality, the more likely a client is to reject the overall set of prices and in an extreme case, cease all negotiations;

Reaction – Clients can take advantage of exceptionally high or low prices by way of making changes to a project's design or specification and initiating the necessary variation orders;

Being Wrong – Contractors will obviously not be 100% correct in their assumptions when pricing a project and therein lies a further risk.

Shrestha *et al.* (2013) explains that whilst researchers acknowledge the risks associated with unbalancing a bid, many do not incorporate these risks into their models. Nonetheless, these risks can serve to erode the benefits of unbalanced bidding if contractors are not careful.

UNBALANCED, UNETHICAL

Rahman *et al.* (2010) identified item pricing as one of the most unethical practices in a survey. More generally, tendering has been identified as a key area of "opportunity for ethical dilemmas to arise" (McCarthy, 2012). Ethically questionable behaviour, however, is not limited to the tender stage of construction. Ho (2011) reveals research indicating that threats, conflicts of interest, bribing and fraud are all issues plaguing construction and the reputation of the industry. For many, item pricing in construction

is believed to be a very unethical practice. It is felt that it involves deception and an immoral pursuit of more profits than contractors deserve. In this context, item pricing is regarded by many as being of equal ethical concern as any of these other problems.

In a substantial industry like construction, which contributes some 10% of the GDP activity in the UK (Ho, 2011) and 6.8% of the GDP in Australia (ABS, 2010), it seems inevitable that there will always, unfortunately, be some unethical players bending the rules in an attempt to make easy money or, at very least, survive during challenging times.

For clients, construction projects are invariably substantial investments (and ones that entail significant risk) and so clients' sensitivity to unethical behaviour is arguably higher than it might be for many other economic activities, in other sectors.

It could therefore be argued that item pricing is plagued by being part of an environment where clients and professionals are highly sensitive and inherently distrustful and suspicious of unethical behaviour – regardless of whether unbalanced bidding is being practiced or not. Interestingly though, this is nevertheless an industry where there is little in the way as barriers to entry and where the players involved do not display track-records of substantial profits. Indeed, to the contrary, it is an industry beset by significant rates of corporate failure (Kenley, 2003) where many contractors fail on account of their high risks, very thin margins and poor cashflows. The margins involved (by contrast to industries such as oil and gas, mining, and ICT) do not suggest that profiteering is widespread or that contractors have any unfair 'upper-hand' advantage over clients.

PHILOSOPHICAL INTERPRETATIONS

Do the philosophies of Aristotle or Immanuel Kant throw any light on item pricing as an ethical practice?

Aristotle

In Nicomachean Ethics, Aristotle puts forth the Function Argument which is his judgment on how human beings can flourish. Aristotle uses the word 'Eudaimonia' to describe the human good. There are a number of interpretations of the word 'Eudaimonia' such as happiness, however, "it is more accurately defined as *flourishing*" (May, 2010).

Aristotle was of the opinion that human beings can flourish by performing their '*ergon*' well. Ergon is the word used by Aristotle to describe what the "function/task/work" (Kraut, 2001) of something is. An example of ergon

is as follows: the ergon of a construction contractor is to construct a building well (to clients specifications).

Aristotle views the word "good" differently when comparing his understanding to that of other philosophers both modern and ancient such as Immanuel Kant. He views "the word 'good' to denote an ultimate end or goal... Aristotle's notion is concerned with goals, no more, no less" (May, 2010). His view of good is not concerned with the morality of the decision process employed to arrive at the ultimate goal.

Aristotle discusses "manmade production in his *Theory of Causality*" (May, 2010). He identifies that there are four components which form his theory, "the material, efficient, formal and final" (May, 2010), explained as follows:

1. *Material* – comprises the physical elements required to produce the "thing".
2. *Efficient* – This is what starts the production of the item. In construction the efficient would be the main contractor.
3. *Formal* – denotes the functional nature of the object. In the case of a building this would mean appropriate indoor air quality, visibility, efficient drainage and construction to specification standard, as well as the functional nature of the building serving as an investment to the client.
4. *Final* – refers to the actual product that has been created to satisfy the formal i.e. the building.

To relate this back to the field of Item Pricing, according to Aristotelian ethics, it is perfectly acceptable, for a contractor (the 'efficient') to price an item or items exactly how they see fit, so long as the building is constructed to the standard specified in the construction documentation and specifications (i.e. the material, formal and final causes are satisfied). The reason this is so is because, Aristotelian ethics denote the greatest good as the best end result, rather than define the most ethical process of arriving at a particular outcome. Other philosophers such as Jeremy Bentham share views similar to that of Aristotle's utilitarian view, that outcomes ought to be assessed by determining which option provides the greatest good to the greatest number of people, as opposed to a deontologist's view which suggest "examining the nature of actions and the will of agents rather than goals achieved" (Kay, 1997) is the best way to determine ethics of a process or decision..

Since item pricing provides the contractor with an effective tendering strategy by which to be competitive, and the client with the building they

desire, arguably with less financial distress than they could accomplish without an upfront-loaded cashflow, this outcome provides the greatest good for the greatest number of people. By contrast, balanced bidding is financially detrimental to contractors and places their cashflows under considerable stress, seemingly providing a good (superficial) end result for one party, the client, and a less than optimal outcome for the contractor.

Immanuel Kant

Kantian ethics seeks to attain and "promote the highest good, or *summon bonum*" (Van Der Linden, 1950). The highest good is "defined as moral society in which human beings attempt to make one another happy" (Van Der Linden, 1950).

The philosophy of Kant differs from that of Aristotle, who believes the outcome of a scenario justifies the means of arriving at that outcome. Conversely, Kant is concerned with the way in which this outcome is reached. He puts forward the Categorical Imperative as the "central moral principle of his ethics" (Van Der Linden, 1950). A categorical imperative is an unconditional obligation employed upon all humans to act in a certain way. Whilst, "hypothetical imperatives apply to me only on the condition that I have and set the goal of satisfying the desires that they tell me how to satisfy, categorical imperatives apply to me no matter what my goals and desires may be" (Rohlf, 2010). Six formulas make up the categorical imperative, the first of which is the most relevant to construction item pricing.

The Universal Law Formula – "*Act only according to that Maxim by which you can at the same time will that it should become a Universal Law*" (Van Der Linden, 1950). For clarification, a maxim refers to a "subjective rule or policy of action: it says what you are doing and why" (Rohlf, 2010).

In construction, contractors have the freedom of choice to bid how they like – for which they must face the consequences. This creates competition in the market place and competition is typically regarded as being of benefit to many industries as it encourages competitors to provide superior products or services (Olsztynski, 2004). This may be especially so in an industry such as construction where there is always fairly-considerable risk and uncertainty and where the nature of work is often unprecedented and bespoke. The freedom of being able to bid in whatever manner they like is argued as cause for making contractors 'happy'. The result of competition in the market drives competitive prices, which give the client more value (be it value in terms of lowest bid, quality of workmanship, best life cost etc.) and this presumably makes the client 'happy'.

If contractors are entitled to price items how they wish and clients are entitled to observe this and enjoy the freedom to react however they wish to (in other words, without being exposed unfairly to or having to accept any abuse by way of this behaviour by contractors) it is suggested that Kantian ethics deems the practice of unbalanced bidding as being moral.

OTHER INDUSTRIES

Business practices similar to item pricing in the construction sector, occur in industries other than construction. However, it is argued that these are deemed more acceptable and not criticised nearly as widely as in construction. One example of this is the widespread practice of Loss Leader pricing. "Loss leader pricing is an aggressive pricing strategy in which a store sells selected goods below cost in order to attract customers who will, according to the loss leader philosophy, make up for the losses on highlighted products with additional purchases of profitable goods. Loss leader pricing is employed by retail businesses" (Inc., 2013) as a way to get buyers through the doors and hopefully spending money on other items in which the gross margin is much higher.

Loss Leader pricing falls into a category known as baiting, in which a number of similar strategies exist, such as bait and switch and bait and hook (Small Business Ethics, 2009). Whilst there are laws in various parts of the world prohibiting retailers from pricing below cost, loss leader pricing is a popular retail practice.

Loss leader pricing is arguably similar to construction item pricing in that the vendor is pricing some items with a relatively low (and potentially negative) gross margin and other items with far higher margins. The conclusion can be drawn then that this is, effectively, an unbalanced pricing strategy.

Similar to construction item pricing, loss leader pricing is not without its risks. If a retailer advertises a particular product for a very appealing price (as a loss leader) it is a risk that customers will purchase that item alone and not purchase anything else. Besides the risk that customers may *reject* the vendor's overall pricing strategy (presumably because they fear being abused by way of the vendor's pricing strategy) they may otherwise *react* by only buying the loss leader items. This is no different to construction item pricing where the client is under no compulsion to accept the contractors' prices and can *reject* them or *react* to them as described earlier. By comparison, unbalanced bidding appears to be far more widely regarded as unethical than loss leader pricing in the retail sector.

"Lawsuits alleging that some loss leader pricing strategies amount to illegal business practices" have been on the increase, however few are successful (Inc., 2013). Nevertheless, this may be argued as indicating some discontent.

Loss Leader type pricing strategies are not just limited to the retail sector. Banking institutions have been known to employ similar strategies. An example of a bank using a similar strategy is when a "commercial lending arm of a large bank gives a corporate client a below-market interest rate on a loan. The reason for the discounted rate: The bank is angling to improve the chances of winning high-margin contracts for its investment banking division, where it would hope to more than make up for any discount" (Cappelli and Herring, 2011).

It is suggested that many professional firms also employ these strategies. Architects and quantity surveyors, for instance, regularly discount or forfeit fees at the early speculative stages of projects and make up for this later on. Accountants and lawyers likewise rely on some types of work (such as auditing) as their 'cash cows' whilst other work (such as tax advice) may not be nearly as lucrative for them. Indeed, it is proposed that any such firm that charged for all their work on the basis that it was all equally profitable would even likely attract suspicion and scorn if it were to do so. Clients are unlikely to be attracted to being billed for every minute of consultation, especially when they are at the stage of merely testing out ideas, accepting that later on the fees will become owing once projects begin to take shape.

Schrand (2011) says these pricing strategies are "not necessarily unethical". Schrand likens the practice to that of a retailer handing out coupons and it is a valid and logical comparison. The idea of handing out coupons is to attract a shopper to a store and hopefully make money out of that shopper in excess of the amount of the voucher as they purchase additional items at full mark-up. Once again, discounting a certain amount to then collect higher margins on other items is the strategy being employed.

Internet marketing services like Groupon, LivingSocial, Google Offers, Amazon Local and Facebook Deals could also be argued as making widespread use of unbalanced bidding: indeed going so far as to facilitate this as a strategy as the core service that they have to offer (Pinola, 2011).

Item Pricing, in principle, is therefore widespread as a strategy across many industries. However, it appears to be more openly accepted and

treated less as being unethical than in the construction industry. The broader issues as regards this industry's reputation appear to be a contributor to the construction industry being singled out.

Trust

It is possible that in addition to the construction industry's reputation, other fundamental issues are contributing to the notion that construction Item Pricing is an unethical practice. Trust is a likely factor in this mix. Trust is defined as a willingness to rely on the actions of others, to be dependent on them, and thus be vulnerable to their actions... it affects the willingness to cooperate" (Wood and McDermott, 1999).

Friedman (2005) states, "It is trust that allows us to take down walls, remove barriers, and eliminate friction." It would be safe to assume then that without trust any practice is bound to be adversarial and a magnet for critique and disapproval to at least some degree.

Furthermore, in any instance where trust is compromised or non-existent anything innovative, new, different or even just not fully understood, will be met with resistance. In construction, corruption, bribery and deceptive behaviour have contributed to a breakdown in trust between contractors and clients. In addition to this Cox and Townsend (1998) suggest that the structure of the construction industry itself, from both supply and demand perspectives, encourages adversarial relationships. When an adversarial relationship exists it is likely that trust will breakdown and in turn the willingness to cooperate will decrease.

Therefore, with respect to construction item pricing, it could be plausible to suggest that due to a distinct lack of trust between clients and contractors, clients will resist individual item pricing in an attempt to eliminate their vulnerability to the actions of contractors, despite in reality, item pricing being arguably potentially beneficial for both parties and an important potential contributor to the contractor's efficiency and viability.

It is possible that trust, or the lack thereof, when coupled with other negative factors surrounding the construction industry could be a likely factor in giving rise to the notion that Item Pricing is unethical, even though item pricing itself, as a practice, has nothing to do with this lack of trust.

INFORMATION ASYMMETRY

Information asymmetry exists when "a party or parties possess greater informational awareness pertinent to effective participation in a given situation relative to other participating parties" (Clarkson *et al.*, 2007).

This is certainly a relevant aspect of item pricing and tendering in the construction industry in general. In a construction project, information asymmetry regarding costs and prices exists between the contractor and the client. The client is aware of and has access to the contractor's prices; this information is required to enter into an agreement. However, information asymmetry between the two parties exists in relation to the contractor's costs. The client is not aware of the contractor's cost estimates, how they have been compiled, what percentage has been added for profit, overheads, risks and preliminaries etc. Clients do not prescribe to contractors how to estimate a work item, just as there is no one singularly correct or industry-standard way to estimate the cost of any such item. Similarly, there is no one mandatory percentage a contractor must assign to each item to account for profit, risk, overheads, preliminaries etc.

In this environment of information asymmetry, where there is also not a strong trust typically between the parties, cooperation can break down and the less-informed party may seek to minimise their vulnerability.

Clarkson *et al.* (2007) defines this sort of information asymmetry as vertical information asymmetry, as one entity "holds information that another does not" (Clarkson *et al.*, 2007). The only way to counteract this is for the party with more information (the contractor in this instance) to disclose their information to the less informed party (the client). This might be easy for some nature of costs (such as materials) but is likely to be far more controversial and complex for others (such as plant and the recoupment of indirect costs such as training, the definitions and derivations of labour productivity, etc.).

As such, the fact that this form of information asymmetry exists in an industry struggling to build trust amongst its stakeholders, could be a likely trigger to give its players the opinion that item pricing is unethical.

CONCLUSION

This paper has investigated the merits of claims that construction item pricing is an unethical practice. Looking to the philosophical beliefs of Aristotle and Immanuel Kant it has been found that both of these important philosophers, who's views differ greatly, could arguably condone item pricing as an ethical practice, refuting claims that it is unethical.

It has been suggested that these claims of immorality instead appear to arise for reason of the environment of the construction industry. The issues of trust, information asymmetry and the industry's reputation and history are suggested as being the likely causes of people's negative opinions of item pricing.

In conclusion, the paper has found that it is highly likely that although item pricing is looked at by many as being unethical, it is not the practice itself causing this opinion. When similar practices are employed in other industries, they are not viewed negatively. It is likely that many other factors related to and caused by the construction industry, as noted above, are reflecting negatively on the practice and prohibiting its acceptance as a legitimate and, more importantly, ethical practice.

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